AN ASSESSMENT AND RATING OF THE BULGARIAN BANKING SYSTEM: 2001

I. Introduction

The following assessment of the Bulgarian banking system has been produced under contract to the United States Agency for International Development/Bulgaria by Michael Borish and Company, Inc. Michael Borish and Company, Inc. would like to thank Debra McFarland (USAID/Bulgaria Mission Director), William Foerderer, Rayna Dimitrova, David Lieberman, Ivanka Tzankova and Nora Ovcharova of USAID/Bulgaria for their kind support and guidance. Michael Borish and Company, Inc. would also like to thank the many people who provided time and documentation for this assessment to be carried out with effectiveness. A list of the people with whom the team met is found in Annex 5. Michael Borish visited Bulgaria from April 29-May 11, 2001, in conjunction with this project.

The banking sector assessment is an update from an earlier assessment conducted in early 1998, shortly after the introduction of the currency board arrangement and major new legislation and regulations for the banking sector. This update is different from the one conducted in 1998 in that it has substantially more information (due to increased availability of information in Bulgaria), and it includes a comparative annex (see Annex 3) with banking sector indicators in Romania and Poland. These two countries were selected for ease of relative peer comparability with Romania (e.g., second-tier EU accession country, relatively late reformer), and similarities in many banking sector reform approaches with the more advanced Poland (e.g., substantial investment in banking supervision development, movement from a fairly insular approach to foreign investment to a more open environment).

In addition, the banking sector assessment (along with inputs from many other firms) is being used by USAID as part of its strategic planning exercise for the next three-five years of assistance. It should be noted that the work conducted by Michael Borish and Company, Inc. in this regard is based strictly on the firm's own assessment of developments in Bulgaria, and does not in any way bind USAID to those recommendations. A separate document related to USAID projects, performance indicators and recommendations can be found in a separate volume entitled "Considerations for USAID Financial Sector Assistance to Bulgaria: 2002-2006".

II. Methodology of the Banking Sector Assessment Rating System

The rating system utilized to assess the banking sector of Bulgaria is based on a review of more than 200 issues and topics that have been used to construct a diagnostic methodology for the review of banking systems. This tool has been utilized by USAID in other transition economies, and is applicable to virtually all banking sectors in the world.

In its simplest form, the rating system is focused on four general areas of activity—based on 28 "sub-categories," and subject to five general classifications. The activities and sub-categories include the following:

USAID Banking Sector Rating System Activities	
General Areas of Activity	***Sub-Categories***
Financial Sector Infrastructure	• General policy and system • Legal framework • Regulatory and supervisory capacity • Payments systems • Accounting framework • Rating agencies • Financial media • Professional associations • Academic institutions • Miscellaneous areas relevant to financial sector infrastructure—telecommunications, postal, safekeeping
Economic Factors and Indicators	• General trends • Private sector development issues • Monetary and related savings and credit matters • Fiscal considerations • Exchange rates • Balance of payments issues
Banking Structure and System Profile	• Overview of the system and financial measures • Profile of ownership structures • Governance and management issues • Non-bank competition
Banking Sector Development Based on Prudential Norms	• Capital adequacy • Asset quality • Management capacity • Earnings • Liquidity • Operating environment • Transparency and disclosure • Sensitivity to market risks

The following classifications are utilized to provide a scoring for the individual issues assessed, as well as in developing a composite rating for the banking sector as a whole. Annex 1 provides greater descriptive detail about how the ratings apply by sub-category. Essentially, the methodology matches the description of the rating for each of the 28 sub-categories, assigns a rating for each, synthesizes the collection of ratings by each of the four areas of activity, and then ultimately arrives at a composite rating for the country. No effort is made to weight individual variables, or to quantify ratings along mathematical lines. Rather, 28 major sub-categories of the four main groupings are all rated within the five-point rating system, with allowances for pluses and minuses in the event that the direct numerical classification does not fully match with performance. The evaluation is both qualitative based on trends and assessments, and quantitative to the extent the figures are useful and meaningful. In the case of Bulgaria, the ratings by each sub-category also take into account trends from the 1998 assessment.

USAID Banking Sector Rating System Scoring Description	
5	Outstanding; world class; state-of-the-art; best practices; virtually no serious systemic risks
4	Solid; strong; satisfactory; competitive; few systemic risks or problems, and those are manageable
3	Adequate; favorable trend; improvement needed; potential for major systemic risks
2	Inadequate; weak; significant improvements needed; major potential for destabilization via systemic risks
1	Dismal; monopolist; resistant to competition and change; no confidence; widespread corruption; weak institutions

It can be noted that the current assessment is far more comprehensive than the earlier one conducted in 1998. This has much to do with greater availability of useful information, the willingness of bankers to speak more freely about their problems and challenges, and the achievement of macroeconomic and banking stabilization that was only partly in place in early 1998. At the time, most major banks were still state-owned, and financial information was weak. By early 2001, financial and statistical information are still not strong, but they are vastly improved and more openly available than in 1998. In particular, the banking sector and the Bulgarian National Bank (BNB) have established web sites that disseminate useful information about the financial condition of banking institutions. Several web sites also convey the impressions of bank management on market developments.

III. The Bulgaria Rating

The composite score awarded for 2001 (based on 2000 data plus trends into 2001) in Bulgaria is **3**, as compared with **2+/3-** in 1998. The improved rating reflects modest progress in most areas evaluated, and impressive progress in a few areas. Most important is the achievement of macroeconomic and banking sector stability, which now presents an opportunity for banks to move on to the next stage of intermediation and risk assumption. Specific to the banking sector, them most impressive accomplishment has been strategic privatization, which is expected to professionalize banking standards, governance and management and enhance system competitiveness. Based prudential norms, virtually all categories showed equal or improved performance (i.e., capital, asset quality, liquidity, operating environment, transparency, sensitivity to market risk), with the only weakness being in the unimpressive level of earnings. From a macroeconomic and structural standpoint, the economy has shown improvement in terms of real growth, monetary and fiscal discipline, and the balance of payments. The private sector now plays a more prominent role in the economy. As for financial sector infrastructure, modest progress was noted in the legal framework and role of associations. BNB's supervision department continues to make progress.

Negatives and weaknesses specific to the financial sector that prevent a higher rating include many of the banking sector aggregates (i.e., size of assets/deposits/capital, lending to the real sector, number of banks with limited lending authority and product offerings) and still under-developed non-bank financial services. These weaknesses are compounded by inefficient and unproductive methods of privatization in the enterprise sector, continued weak information and data on borrower credit worthiness, judicial enforcement of creditor claims when borrowers default. The absence of an adequate bank resolution framework, and currently untested risk management systems at many banks will also present a challenge as lending and risk profiles increase. Thus, as of summer 2001, the assessment of the Bulgarian banking system is as follows:

The Bulgarian Banking System—Summer, 2001	**Composite Score: 3 (as compared with 2+/3- in 1998)**

The Bulgarian banking system has undergone considerable transformation since economic collapse in 1996-early 1997. The authorities initiated major changes in the legal and regulatory framework in 1997-98, introducing a currency board, stabilizing macroeconomic fundamentals, and putting the banking system on a privatization track based on open markets and the attraction of strategic foreign investment. These objectives have been achieved, an impressive accomplishment in light of economic collapse four years ago.

From a macroeconomic standpoint, the authorities have been effective in maintaining monetary stability and achieving near fiscal balance. Gross foreign exchange reserves now provide significantly greater import cover than in 1996, largely on the strength of rising exports and steady increases in foreign direct investment.

In terms of banking, Bulgaria has privatized five of the six major banks slated for privatization, and only four state banks remain. The five banks privatized since 1998 include Bulgaria's two largest, both of which were privatized via strategic investment from EU member state banks. In effect, Bulgaria shifted ownership of the banking system from 82 percent state ownership of assets in 1996 to 80 percent private ownership by end 2000. While lending to the real sector is still low at 12.5 percent of 2000 GDP, it is poised for growth now that strategic investors are in the market, IT and MIS are coming on stream, margins have shrunk in the corporate sector, and banks are seeking higher returns. In addition, Bulgaria has introduced a deposit insurance scheme that provides modest coverage (up to 6,900 leva), and has already administered two failed bank deposit payouts without any noticeable panic in the marketplace.

Recognition of Bulgaria's accomplishments has manifested itself in an invitation from the European Union in December 1999 to commence formal negotiations for entry into the EU. This has been followed by a steady increase in trade with the EU and other advanced countries, along with increasing regional trade with other EU aspirants (CEFTA and others).

Notwithstanding Bulgaria's accomplishments, several weaknesses and problems remain. The legal and institutional framework remains weak, particularly in the judiciary. Accounting, statistics and financial information are inadequate and incomplete. There is limited infrastructural capacity in terms of credit information for more systematic and precise risk classification of borrowers prior to lending. The absence of an effective bank resolution framework is unfortunate, and will need to be remedied if Bulgaria is to manage the failed bank process in a more systematic, transparent and predictable way. Many Group IV banks appear limited in terms of what they can offer in terms of size, and a few are reported to be weak and/or engaging in financial practices of questionable legality or prudence. The non-bank sector remains weak and underdeveloped. Earnings in the banking sector are unimpressive and insufficient for the needed investments for modern banking systems and technologies. In the real sector, accounting standards are poor, projects are often infeasible, financial requests are often predicated on excess leverage, and disclosure practices of companies undermine confidence in credit quality. At the structural level, privatization by management-employee buyout or mass privatization via vouchers has not produced adequate incentives for improved performance and enhanced credit worthiness.

The conclusion is that conditions have improved since 1997-98, and the authorities are to be commended for following sound policies in support of stabilization, market discipline, and strategic privatization. This has been combined with some notable progress in terms of institutional capacity, namely banking supervision. However, many banks and regulators are untested in new and more complex areas of risk that are likely to be present in the market in the coming years. Intermediation levels can be expected to increase, particularly in the consumer/retail market. With increased lending and risk will come losses and some measure of consolidation. The net effect will be positive, although the market, the public, and the supervisory authorities will need to contend with higher degrees of volatility than they have encountered in the last three-four years.

- **The banking system is now majority private and foreign-owned**—all but four banks are private; foreign banks account for 75 percent of total assets; state banks only account for 20 percent of assets

- **There is still high concentration** in Bulbank (foreign trade bank) and DSK (local currency household deposits), but concentration is diminishing with competition
- **There are 35 banks in Bulgaria, and increased competition should eventually trigger consolidation**—mainly of the Group IV banks are small and limited in terms of what they will be able to provide to the marketplace as the larger banks penetrate the retail market and offer a broader spectrum of products and services
- **Total assets of banking system are less than $5 billion** (average assets approximate $133 million per bank)—most banks are small
- **Total deposits are less than $3.4 billion** (average deposits are less than $100 million per bank), even though deposits account for nearly 80 percent of total funding
- **Banks have high levels of regulatory capital, but are small in terms of aggregate capital**—CARs are 35.6 percent, but total capital is only $656 million ($24 million on average)
- **Asset quality has improved**—standards loans are 92 percent of total; loss loans are only 3.4 percent of total
- **Lending to the real sector is low, at 12.5 percent of 2000 GDP, but expected to increase in the coming years**—banks have stayed away from lending to companies and households in recent years if borrowers and their projects have not complied with banks' underwriting standards; now that conditions are more stable and real GDP growth is expected to continue in the 5-6 percent, there are better prospects for lending on the condition that enterprises and households provide better documentation and projects for financing; banks are expected to make an aggressive push into retail banking once systems are in place, market research is finalized, and personnel are trained
- **Earnings are unimpressive, narrow in sources, and predicated on negative real rates paid on deposits**—banks earned a total of $133 million in 2000, only $4 million per bank
- **ROE (20 percent) and ROA (3 percent) are acceptable for now, but will come under pressure when competition heats up**—the earnings base is currently too small for these returns to be considered sufficient
- **Most banks have excessively high levels of overhead**—there are 21,000 bank employees (600 on average), but some of the traditional banks have much higher staffing than is needed; this will continue to serve as a drag on earnings, while other banks rely increasingly on improved IT and systems for more efficient service delivery and operational control
- **Management capacity is still variable, and risk management systems are largely untested in Bulgaria**—banks are only now beginning to assume risk in lending and related activities; the majority of earning assets are still in low-risk investments, mainly in offshore banks that require minimal risk management capacity
- **Banks have high liquidity ratios**—this reflects banks' aversion to lending in an environment that has been less than conducive until recently, and is driven by banks' investment in safe securities on top of prudent regulatory requirements
- **There is limited market risk in Bulgaria**—banks' capital and liquidity ratios are high, exposures are generally within limits, and mismatches in exchange rates, interest rate features, or maturities are not considered so broad as to put the system at risk
- **Bulgaria has weathered political risk well in the last few years, suffering less from contagion effects than other emerging markets**—the currency board and strict prudential framework for banking has insulated the system from much of the volatility that has affected other markets in recent years

The basis for the composite is described by each of the four general activities and the 28 sub-categories below. A detailed assessment is attached as Annex 2. Readers are encouraged to read through Annex 2 for supporting information and data to justify the findings and ratings applied.

Section 1: Assessment of Financial Sector Infrastructure

***I. Financial Sector Infrastructure : Score: 3** (vs. 3- in 1998)*

Bulgaria has made progress in advancing its financial sector infrastructure since 1997, and the invitation to join formal negotiations for accession to the European Union should keep the reform effort on track. However, much progress has gotten bogged down in the difficulties of implementation.

General policy has been supportive of a market-based system since after the collapse of 1996. This has been evidenced by the willingness of the authorities to permit strategic foreign investors to obtain a collective majority stake in the banking system. By contrast, the government could have embarked on costly restructuring exercises to strengthen domestic banks before the entry of larger foreign banks. That it did not reflects policy supportive of increasing integration with Europe at the expense of protection for uncompetitive domestic financial institutions.

Laws are comprehensive for banking, although there are still shortcomings that are being addressed in the insurance sector. There is also a gap in terms of an effective and modern bank resolution framework linked to the ongoing viability of the deposit insurance fund. However, most of the problems in the legal domain relate to court capacity, the absence of precedent consistent with market practices, the traditional anti-creditor bias of many judges, and general judicial capacity weaknesses.

The regulatory framework is firm for banking, although it is less settled in the insurance sector. Weaknesses in banking supervision include the need for more advanced early warning systems, improved reports from the banks, and additional training needs for supervisory staff in new risks that are likely to emerge as the system becomes more competitive and complex. However, for now, the Banking Supervision Department (BSD) has made substantial progress since 1997, and it is viewed as adequate relative to the risks being assumed by the banks at the moment. However, as noted, these are expected to become more challenging in the coming years, and BSD systems and staff will need to adapt. This is considered far more problematic and challenging in the insurance sector, where institutional capacity lags that established in banking.

Accounting and financial information remain relatively weak in Bulgaria, although bankers have managed to adapt credit risk evaluation methods to the environment to reduce the level of non-performing loans. Meanwhile, external auditors have managed to help the banks improve their information systems, and to comply with regulatory standards and reporting requirements. However, the profession has many gaps in it, not the least of which is the small number of chartered accountants in IAS and auditors in ISA. Most registered firms still follow tax-oriented practices, and many bankers are still unable to lend (even when they know a firm is a good credit risk) because of the violation of underwriting standards that would ensue.

Otherwise, developments are fairly positive. Bulgaria is moving to Real Time Gross Settlement in 2002. While the BNB credit registry is not as comprehensive as bankers would like, they do use it. This is an advance from 1997-98 when the system did not even exist. Private rating agencies have rated a handful of banks and insurance companies, and this may increase in the coming years if Bulgaria is successful with structural reform. The financial media appear reasonable, and many regulators and market players have web sites to broaden public disclosure of information. There are several active associations that are playing a constructive role in legislative/regulatory reform and policy discussion. Improvements in telecommunications are making it possible to move on with needed modernization of MIS, IT, and electronic banking.

1.1. Policy and System: Score: 3+ *(vs. 3 in 1998)*

Bulgaria showed significant progress in 1997 after economic collapse in 1996. **Policy has been geared to stabilizing the macroeconomic framework**, with evidence of this in the form of relatively low inflation rates (notwithstanding the 2000 increase), fiscal discipline, satisfactory levels of foreign exchange reserves to sustain the currency board arrangement, and responsible debt management that has maintained international confidence in the underlying economy. The proof of this confidence is in the relative lack of concern about problems in Turkey spreading to Bulgaria (apart from a potential minor change in export earnings), which differs substantially from the contagion effects that have affected investor sentiment in other emerging markets.

Nonetheless, while the previous government was committed to establishing an environment conducive to market development (with partial success), **it was not as successful in implementing structural reforms in the real sector**. Numerous problems have surfaced in the realm of privatization and corporate governance. In the financial sector, judicial capacity weaknesses have been exposed with regard to bank resolution, while accounting and financial information weaknesses persist due to poor (and manual) internal systems, fragmented intra-bank reporting, and lack of experience with risk-based management reports. In general, there is a view that government policy is undermined by weak information, a lack of depth in understanding the complexity of financial sector issues, and relatively thin capacity below senior levels in the implementation of new laws and regulations. Overall, there is a sense that reforms are reactive, causing significant cost and burden to the system, undermining needed certainty for investment, and generally lacking in medium-term vision. The recently elected government faces the challenge of reversing these trends.

In addition, **Bulgaria faces the challenge of correcting structural imperfections. This can be done with time, particularly if there is a cohesive strategy that more effectively harmonizes the legal, tax and institutional framework for modern financial services**. In general, government policy has been supportive of development of a market-based system since 1997. The invitation to enter negotiations for EU membership will help to consolidate gains, and provide incentives for difficult decisions that will need to be made in the coming years.

1.2. Legal: Score: 3 *(vs. 3- in 1998)*

Major financial sector legislative reform was achieved in 1997 and has been broadly sustained. There are few reported problems associated with banking and insurance legislation by industry practitioners themselves. However, there have been problems and weaknesses associated with the regulatory/supervisory process (in insurance, which is underdeveloped compared to banking) and with judicial processes.

Banking legislation is broadly viewed as effective, although there will be calls for increasing permission from the regulatory authorities to permit banks to enter non-bank activities. This will have to proceed cautiously, although banks with demonstrated capacity and competence from more developed markets should clearly be permitted to move forward in these fields. In the insurance sector, legislation is evolving in line with EU standards.

Insurance sector legislation and regulatory capacity have much further to go in terms of capacity building and implementation as compared with banking. In some ways, permission for banks to enter insurance needs to be pursued cautiously to allow the regulatory authorities to develop the capacity and systems for an orderly insurance market to function.

Meanwhile, **bank resolution represents a critical weakness in the legal framework**. There have been bank closures, but 10 failed banks remain to be definitively resolved. Bank bankruptcy is a court-oriented process in Bulgaria, and is often protracted due to the role of judges and trustees in the process. This often is time-consuming, costly, and of questionable effectiveness with regard to the liquidation of assets. Recent efforts to reform this process stalled in parliament and eventually did not pass. A more efficient, transparent process for bank resolution will need to be in place as a future contingency.

Other changes have recently been adopted, most notably improvements in the Civil Procedure Code to strengthen creditors' rights, mainly in the area of collateral collection. However, here as well, there are problems associated with control of collateral resting with the debtor during periods of dispute, as well as problems related to perfection of liens on securities as pledge registration requirements pertain to the holder of the securities rather than the securities themselves.

There are also concerns about the frequency of amendments and changes to laws, as frequent legal changes can reduce certainty needed for investment and risk-taking. However, in fairness to the previous government, changes in legislation have often resulted from consultations with and recommendations from market players. This is partly driven by EU accession criteria and the greater sense of urgency the government now places on complying with EU directives.

***1.3. Regulatory and Supervisory: Score: 3** (vs. 3- in 1998)*

The laws on BNB and banks have provided for a tightly regulated banking environment to guide Bulgaria through its stabilization process following the events of 1996. BNB has a clear mandate to license, regulate and supervise banks, and it has acted on this mandate since 1997. However, bankers criticize the process as being excessively rules-based, heavily data-oriented, and sometimes inefficient because of the lack of harmonization of regulatory reporting requirements with existing internal systems. In some cases, the communications process has been criticized as being deficient, tardy and incomplete. Given the frequency of regulatory changes, this is disruptive and costly to bank operations. Nonetheless, net of these kinds of criticisms, the banks appear to recognize the strong mandate BNB has to supervise the system.

The Law on Banks is explicit and clear in spelling out requirements of banks within the regulatory framework. Moving forward, **the challenges faced by BNB and Bulgaria's banks relate to moving from a narrow, risk-averse focus on stabilization to a system that is more competitive, generally privately-owned, and driven by the need to generate stronger and more diverse earnings streams for better returns**. With several large foreign banks now present in Bulgaria, competition has already begun in the small corporate sector. Most banks are now embarking on development of retail strategies, including movement towards packages and more complex instruments that have the potential to generate far higher earnings. On the other hand, several banks (among them smaller and largely domestic banks) may be lagging the more dynamic banks in terms of investment in new technologies, development of more suitable MIS, and general market experience. This presents the risk that smaller banks may not be able to compete, or that the less competitive banks may seek to generate higher earnings predicated on strategies that are excessively risky and dangerous. At a minimum, **consolidation can be expected as market development proceeds**. Should this occur, Bulgaria will need to move forward with a more appropriate resolution strategy that is fast, least cost, and consistent with rapid deposit payout.

Beyond that, **banking supervision will need to strengthen its early warning systems** to ensure that issues of adverse selection or large concentrations in the inter-bank market do not undermine general system stability. **Many banks will need to further improve their governance, including internal audit, and general management capacity**.

1.4. Payments System: Score: 3+ *(same as in 1998)*

The Law on the Bulgarian National Bank states that "establishment and functioning of efficient payment mechanisms" is a function of BNB's main task, which is currency stability. Investment in this area as far back as 1992 to protect BNB from unintended overdraft credit and to provide low cost and prompt settlement indicates that Bulgarian banking and monetary authorities appreciate the importance of the payments system to economic stability. There were no major problems reported with the payment and settlement system as is, even though it is not designed to handle large value payments, settlement sometimes takes as long as three days, and banks do not know their exact balances until 10:00 a.m.

More recently, the government decided to accelerate movement towards Real Time Gross Settlement (RTGS) to come closer to meeting EU criteria for eventual monetary union. RTGS is expected to be achieved by mid-2002, and this will provide a number of benefits to the system, including opportunities for more electronic applications of banking (e.g., electronic signatures, e-commerce, internet banking) and more efficient liquidity management.

1.5. Accounting: Score: 3- *(vs. 2+/3- in 1998)*

Accounting standards have improved in the financial sector, although it remains a broad weakness in the real sector. Accounting in the enterprise sector is still driven by tax considerations, and is generally not used as a tool of financial management and planning. Meanwhile, the accounting and audit profession counts only a small fraction of total practitioners as licensed in IAS/ISA. This is beginning to change, but Bulgaria lacks overall accounting capacity for modern business management.

The move to IAS for bank *annual* reports began in 1997, mainly for the state banks to be privatized. IAS was also required for large enterprises slated for privatization. For banks, the role of the external auditor is formally incorporated into banking legislation. This has been used to identify internal audit, systems and technology needs, along with management standards for their operation. **Based on findings from on-site examinations, most banks have begun to make improvements. However, many of the smaller banks still lack what is needed in terms of information systems**. In some cases, this has to do with human error resulting from manual processing. In other cases, it is due to poor reporting forms, fragmented data processing systems, and overstretched management.

International accounting firms have been involved in assisting Bulgarian authorities in modernizing standards. However, applying IAS in a meaningful way at the structural level for useful management purposes continues to take time, and this has been one of the areas where Bulgaria has not made as rapid progress as is needed. **The prime-rated foreign banks have no problems with these issues. However, some of the Group IV domestic banks are reported to have weaknesses in these areas**. There may also be related problems at some of the remaining domestic banks with large branch networks that rely on manual bookkeeping.

1.6. Rating Agencies: Score: 2+/3- (same as in 1998)

There is still little international portfolio investment focus on Bulgaria apart from Brady bonds, which are generally traded in London. The domestic market is practically nil, and financial statistics show that net portfolio flows have been negative since 1998. Given such circumstances, it is all the more impressive that Bulgaria has been able to privatize its banks with strategic foreign capital.

There is still strict observance of confidentiality by the authorities. This undermines disclosure practices, and has kept the BNB credit registry modest in terms of information dissemination. Meanwhile, private rating agencies have played virtually no role apart from a few ratings, mainly on sovereign ratings and a few of the larger financial institutions.

1.7. Financial Media: Insufficient Basis for a Score

No particular effort was made to assess the financial media. However, there are several newspapers that report daily and weekly figures regarding monetary issues, trade volumes, exchange rates, etc. This is consistent with the improved legal environment for BNB and the commercial banks, and appears to reflect a commitment to increased public disclosure. The reporting appears to be professional, accurate and objective.

In addition, BNB, the banks, brokers, insurance companies, and other financial institutions have web sites that provide information on their status along with commentary. In general, information flows appear to have increased since end 1997. The recent EU report on Bulgaria's progress toward EU accession reported no problems with issues of information and media communications in Bulgaria, including (by extension) in the financial sector. While there are rumors, half-truths, and sometimes unsubstantiated reports, the financial media generally provide a useful amount of information to the public.

The Law on Banks does specify that the dissemination of false information that can undermine the reputation of a bank can lead to a fine of 50-200 million leva—up to nearly $100,000 at end 2000 exchange rates—for media concerns. Higher penalties can be assessed if criminal activity is proved.

1.8. Professional Associations: Score: 3- *(vs. 2+ in 1998)*

There are many business and professional associations focused on financial sector development. **The Association of Commercial Banks (ACB) is the main banking association,** coordinating with the banks on a number of regulatory issues and working with BNB, MoF and Parliament. ACB also coordinates with the International Banking Institute to provide training to bankers. However, the ACB has been criticized in some cases for not being open and transparent in terms of its efforts to lobby government on behalf of the sector, and for its own appointments and governance practices.

The Bulgarian International Business Association (BIBA) represents the foreign business community, and includes several large international financial services firms, including Allianz and AIG in insurance, 16 of the largest banks, four of the Big 5 accounting/management consulting firms, and other financial firms in leasing, fund management, and development banking. BIBA's recently formulated annual White Paper contained a substantial number of recommendations regarding financial services, taxation, privatization, manufacturing, and other areas of concern. The previous government demonstrated the seriousness with which it took such recommendations by responding point by point in a 52-page tabular response.

There is a 29-member **Association of Bulgarian Insurers** focused on professionalizing standards, ensuring competition and a conducive business environment in the insurance sector, and meeting EU requirements by harmonizing legislation and accounting with EU directives. The accounting profession is represented by the **Bulgarian Institute of Certified Public Accountants**. There is also a **Chamber of Auditors**. The securities profession has the **Association of Licensed Investment Intermediaries**, while private pension funds are represented by the **Bulgarian Association of Supplementary Pension Insurance Companies**.

1.9. Academic: Insufficient Basis For a Score

No systematic effort was made to determine numbers of courses, students, institutes, or other academic matters. Nor was there a systematic effort to speak with business/management school officials. There are several think tanks that make a significant contribution to banking sector reform and development, and general economic policy. There are reported to be about 65 management training institutes in Bulgaria. However, **management training in both financial services and the real sector represents a major need in Bulgaria**. For the banking sector, this is important directly for an adequate supply of professional staff, and indirectly to have greater confidence in the management skills and teams of companies seeking to borrow.

1.10. Miscellaneous: Score: 3 *(same as in 1998, which is now considered too high in retrospect)*

There has been some slow movement towards privatization of the fixed-line telecommunications market. BTC is the fixed-line monopoly, and it is now slated for privatization in 2003-04. **There are two companies operating in the mobile telephone market**, and a third GSM license is expected to be issued by 2002 before BTC's fixed-line monopoly comes to an end. **There has been some development of electronic commerce**, and Bulgaria will soon permit electronic signatures to be used as a stimulus for such transactions. **Safekeeping from a physical and logistical standpoint appears adequate**, and this will improve with movement towards RTGS. However, no systematic effort was made to review this. The postal system still provides payment services for communities that find it difficult to access retail banking services.

Section 2: Assessment of Economic and Structural Factors

***II. Economic Factors and Indicators: Score: 3** (vs. 3- in 1998)*

Overall macroeconomic performance in the late 1990s has shown significant improvement when compared with the volatility and downward trends of the mid-1990s. While overall output has not fully recovered from one year before the transition began, there have been noticeable and impressive accomplishments since the collapse in 1996. **Real GDP growth has been registered for three straight years**, with 2000 having been the best year since the transition began in the early 1990s. While the unemployment rate remains high, the general growth in the economy and recent introduction of measures to make hiring/firing more flexible should help bring down the official unemployment rate. **Pricing stability has been broadly restored** with the currency board arrangement (CBA), as shown in the relatively low inflation rates achieved since 1997-98. **This has been combined with impressive fiscal discipline**, as budgets have been kept largely in balance since 1998. Given the restrictiveness of the CBA, progress on the inflation front could have been undermined by fiscal laxity. This has not been the case.

In addition to relatively low inflation rates, **there has been an increase in broad money and deposit mobilization with the banks since end 1997**. While funds held with the banks are not as high as they were in earlier years, this is largely due to the high proportion of cash transactions that occur. This points to a weakness with regard to compliance with fiscal requirements. Nonetheless, **fiscal revenues are increasing, and the onerous tax burden associated with personnel benefits (e.g., social insurance) and personal income taxes is shifting to consumption-related taxes (e.g., VAT, excise).** Thus, while the informal sector still accounts for a large proportion of activity and tax evasion remains high, there are now signs that fundamentals are improving. The government is in the middle of a tax rate reduction program, and both revenues and expenditure are increasing without incurring deficits exceeding 1 percent of GDP. The new government is contemplating additional reforms that could accelerate some of the proposed changes (i.e., bringing the corporate tax rate to zero when profits are reinvested, raising the threshold for personal taxes). As the fiscal burden diminishes and banks provide more incentives for households and enterprises to place funds in their institutions, broad money is expected to increase. This will have a positive effect on intermediation trends in the coming years.

Meanwhile, **the balance of payments continues to show positive data and trends**. Current account deficits are still high, but the structure of the deficits point to ongoing retooling for export-oriented competitiveness, rather than wasteful consumption of luxury consumer goods. This is also reflected in growing levels of direct investment, some of which is derived from CEFTA and EU investors in greenfield operations. Bulgaria's international transactions have increased in volume, including its exports. This is projected to continue as its trade is increasingly integrated with EU markets, now at about half of total trade as compared with about one third in the mid-1990s. Debt management also continues to be adequately conducted, notwithstanding areas that could be improved with regard to exchange rate and maturity mismatches. Foreign exchange reserves provide Bulgaria with about six months of import cover, debt-to-GDP continues to decline, and the market shows no worries about Bulgaria's ability to meet its international obligations.

Apart from still high levels of tax evasion/aversion, **the main weaknesses in the economy appear to be structural, judicial, and related to the underdevelopment of the capital markets**. While the previous government made significant progress with bank privatization, its enterprise privatization program was less impressive. **The preponderance of management-employee buyouts (MEBOs) has done little to improve enterprise competitiveness, efficiency and governance**. Likewise, mass privatization has provided some compensation to voucher holders, but has done little to promote economic growth. Banks that still have these enterprises as clients are at risk because of their continued restructuring needs.

Meanwhile, **the capital markets have offered virtually no outlet for most enterprises because they are unable to achieve listing requirements. The markets themselves are non-transparent, and turnover and capitalization figures indicate that there is significant work to be done to activate the markets. This effort should focus on strengthening company performance, and not on easing listing requirements to sub-standard levels**. If the latter approach is pursued (allowing for reasonable differences between primary and parallel markets), the benefits of disciplined markets will not generate the kinds of liquidity needed for markets to operate efficiently in Bulgaria. Private pension funds, life insurance companies and major banks offer the long-term opportunity for institutional investors to help develop corporate bond and equity issues, as well as to serve as a source of demand for government securities once the CBA lapses and Bulgaria joins the EMU. However, this is a long way off. In the meantime, companies themselves will need to address a long list of governance, management and financing fundamentals to be attractive to investors on markets. Development of these markets and linkage with regional markets (e.g., Athens, Vienna) would be helpful for the development of securitized products (e.g., mortgage-backed securities, warehouse receipts, factoring), and for exit mechanisms to be in place for venture capital, turnaround companies, vulture funds, etc. As of now, Bulgaria has fared poorly in this area.

Having mentioned structural weaknesses, which include high levels of public sector employment, **there is still irreversible movement towards a private sector-oriented economy**. The general estimate of private sector GDP is about 70 percent. The state remains involved in only a few areas of the economy. Lending to the state sector has virtually disappeared. Thus, while structural weaknesses persist, there is confidence that new investment and increased exports will usher in a more competitive economy based on more sustainable prospects for growth. All of this is in stark contrast to conditions of collapse in late 1996/early 1997.

2.1. General: Score: 3 (vs. 2+/3- in 1998)

Macroeconomic data are broadly positive, and represent improvement from the mid-1990s. Real GDP growth has been steady since 1998, notwithstanding drought in 2000 and a general reconfiguration of the economy since then towards services. Inflation rates have come down to manageable levels from the hyperinflationary period of the mid-1990s. The fiscal accounts are generally in balance. Bulgaria is showing signs of increasing competitiveness, both in terms of labor productivity and in terms of export growth. The latter is impressive considering that its exchange rate is pegged 1:1 with the Euro, thereby providing no flexibility in creating a currency-related advantage to increase exports to its major trading partners. General financial indicators such as debt levels and foreign exchange reserves continue to improve. The latter is partly driven by Bulgaria's increasing ability to attract foreign direct investment, which approximated $1 billion in 2000 for the first time.

Weaknesses are generally at the structural level. Public sector employment remains high, while the unemployment rate also remains high. Informal sector activity continues in the 30-40 percent of GDP range, largely to avoid what are perceived to be onerous tax burdens. Methods of privatization are broadly criticized as having done little to improve competitiveness and efficiency in these companies. Corruption is still pervasive, and many critics believe that some of the larger companies that remain state-owned (e.g., BTC in telecommunications, Bulgartabac) could have been privatized earlier and generated significant proceeds.

2.2. Private Sector Development: Score: 3 (vs. 2+ in 1998)

Bulgaria is on an irreversible course of private sector growth, with particular strength in services and growing strength in the industrial sector. Virtually all sectors of the economy are now driven by private sector companies with the exception of the water, gas and electricity sector, telecommunications (where there is private competition from two GSM operators), and a handful of other companies that are either minor to the economy (e.g., mining) or to be privatized in the next few years (e.g., tobacco, tourism). **Since 1997, private sector output has increased from $6.1 billion (1997) to an estimated $9.1 billion (2000). This has been accompanied by increasing productivity, and more recently, a sizable increase in export volume**.

The structure of the economy has broadly shifted in the last four years. At end 1997, agriculture accounted for 27 percent of output, as compared with 15 percent in 2000. The shift in composition has generally been visible in services, which now accounts for 56 percent of GDP. Industrial share has settled at about 28 percent of GDP since 1997.

In terms of employment, the state remains a major employer, accounting for 47 percent of the total officially employed work force. While government employees and employees of state-owned enterprises are comparatively well paid, the statistics may be off. Private sector compensation is generally less than public sector employment, but it is commonly acknowledged that private sector rates are deflated by employers to avoid/reduce tax obligations. Some of the foregone tax payments from employers are paid in cash off the books to employees.

As for firms and firm size, Bulgaria had about 200,000 or so registered enterprises. It is uncertain how many are operating at commercially viable levels. While the total number of registered firms is about 210,000, another source reported only about 70,000 firms with more than five employees. **It is possible that nearly two thirds of registered firms are operating at sufficiently low levels of utilization to be considered non-viable.** In general, firms are small-scale in Bulgaria.

Government recognizes the need to improve the business environment, and has recently taken measures to make conditions more conducive to the private sector. A significant number of licensing and registration requirements have been streamlined. Direct tax rates on corporate profits, personal income, and personnel benefits (e.g., social insurance) are coming down in a bid to increase compliance. Recently introduced pension reform is meant to shift some of the burden away from employers to employees. Meanwhile, depreciation schedules are being revised to stimulate greater investment in high technology ventures and to stimulate increased re-tooling of manufacturing (including agro-processing). Faster VAT refunds are intended to serve as a catalyst for leasing and other activities that require major up-front investment. The new government appears committed to sustaining these reforms, and possibly adding/accelerating in the form of tax relief on securities transactions, interest income, and retained earnings.

There is still skepticism among many that government reforms and initiatives have not done enough to rein in corruption, to streamline the tax burden, and to move forward with greater transparency in privatization transactions and securities market development. Nonetheless, many of the fundamentals appear favorable, as shown in increasing levels of investment, productivity and export volume. Should real GDP continue to increase at 5-6 percent, as in 2000 and as forecasted, this should help in bringing down the official unemployment rate, making the fiscal base more viable, and increasing Bulgaria's prospects for competitiveness and sustainable growth.

2.3. Money, Savings and Credit: Score: 3+ *(same as in 1998)*

Conditions have broadly improved in terms of monetary policy and management in recent years. The CBA has induced financial discipline, which has translated into relatively stable inflation rates (despite a rise in 2000 due to dollar-denominated pricing of key import commodities, and a general depreciation of the Euro to the dollar) since 1997-98. This compares with the collapse of the Bulgarian economy in 1996-early 1997, during which bank deposits declined from $7.4 billion at the end of 1995 to $1.8 billion at the end of March 1997. While there are still some risks, mainly related to exchange rate and maturity mismatches that could have a marginally destabilizing effect on the economy (e.g., a sharp drop in the Euro would add stress to the debt profile and exacerbate the current account deficit), monetary management has been broadly viewed as stable and contributing to sustainable real growth.

While broad money levels are still below aggregates achieved in 1992-96, there has been an increase since 1997 of about $700 million, or about 20 percent in dollar terms. Deposits held with banks have likewise increased $415 million (net) since 1997. Under the current circumstances in which banks are paying negative real interest rates on deposits, it is actually a significant accomplishment that funds have been mobilized. In fact, the paucity of investment opportunities for banks has served as a disincentive to deposit mobilization efforts until recently, as their assets have been largely placed in low-risk, low-return investments. Banks' movement towards expanding retail/consumer banking operations in Bulgaria reflects a turning point from stabilization to growth. This is expected to alter deposit-related features and pricing as banks increasingly seek to build franchise value. Along with other developments (including tax rate reduction for businesses and households), it is expected that deposits with banks will increase, and that banks may increase rates paid on medium- and long-term instruments to provide greater stability to their funding bases.

In the banking sector, the CBA significantly curtails the abuse of refinancing and lender of last resort embedded in monetary policy and credit practices through the end of 1996. This has translated into low levels of lending, which currently stand at about 12-13 percent of GDP.

However, the last three-four years have had a cleansing effect on portfolios, and **most banks now generally have significant capacity to lend relative to capital levels**. This is particularly true of the Group I-III banks, which are the largest banks. Branches of foreign banks (Group V) likewise can access additional funding as needed. Thus, while there have been critics of the stabilizing developments of the last few years, banks now appear poised to increase their lending and risk assumption. Part of the reason is due to the stable monetary environment created by the CBA, which has also contributed to foreign investment into the banking sector.

2.4 Fiscal: Score: 3+ (vs. 2+/3- in 1998)

Fiscal developments have been broadly favorable since 1997. Policy has been consistently geared to reduced deficits. These were achieved as early as 1997, one year after the economic collapse. Since then, the average fiscal deficit has been less than 1 percent of GDP. Given fairly tight monetary conditions emanating from the currency board regime, this is an impressive accomplishment. As a sign of discipline, financing of the state enterprise sector has been reduced to virtually zero after major financing in the early/mid-1990s.

Meanwhile, the previous government made progress in a number of structural fiscal areas. **Revenues and expenditure have both increased since 1997**, with the fiscal accounts benefiting from a shift away from direct to indirect and consumption-oriented taxation. Rates continue to decline while collections continue to increase. The shift to increasing reliance on VAT and excise, 32 percent of fiscal revenue in 2000, has made it possible for rates to come down on corporate profit tax rates, personal income tax rates, and mandatory employer social security contributions. The new government has expressed an interest in accelerating reforms in these areas.

Meanwhile, all of this has been accomplished despite dubious competitiveness resulting from privatization transactions, high levels of tax avoidance, and continued high stocks of external debt that are regularly serviced through the budget in six month intervals. **Continued growth in real GDP and international transactions, recent improvements in VAT refund provisions, and continued reductions in personal/corporate tax rates should continue to increase the fiscal base and revenues**.

2.5. Exchange Rates: Score: 3+ (vs. 3 in 1998)

Bulgaria's exchange rate policy has been fixed to the DM and then Euro since introduction of the CBA. This followed a period in which the earlier Bulgaria lev had depreciated rapidly from 1995 to 1996, reflecting the earlier policies that relied heavily on borrowing and refinancing to prop up inefficient state industries and government operations.

The two basic weaknesses Bulgaria faces with the CBA are the inability to permit the currency to depreciate as a catalyst for increased investment and exports, and the current deterioration of exchange rates in relation to the US dollar. The latter is important due to the structure of Bulgaria's debt (which is about 65 percent dollar-denominated), and the international pricing of imported energy and other commodities in dollars. Meanwhile, as long as the Euro remains weak against the dollar, this will make debt service and the import bill more costly. Bulgaria also cannot pursue a currency devaluation policy to stimulate exports to its major trading partners in the EU. On the other hand, the CBA has benefited Bulgaria's economy with strict and predictable discipline that has squeezed out virtually all of the earlier leakage that brought Bulgaria to economic collapse in 1996. **The recent increase in FDI and export volume, combined with broadly favorable macroeconomic indicators suggests the benefits of the**

CBA have outweighed the costs during the last four years of stabilization. Moreover, public opinion polls continue to show that the public firmly backs the CBA as a source of pricing and exchange rate stability.

2.6. Balance of Payments: Score: 2+/3-(vs. 2- in 1998)

Bulgaria's balance of payments has shown generally positive results in recent years. **While there has been an increase in the current account deficit, this is partly due to the increasing importation of goods being used to make manufacturing and services more competitive**. The results have already been manifested in increasing exports, primarily in petroleum products and footwear and leather goods. Meanwhile, interest service figures are higher due to dollar-denomination of the balance of payments. While this reflects the composition of debt and exchange rate movements, there has been no market concern about Bulgaria's ability to service or repay debt in a timely manner.

Since April 1997, Bulgaria's economy has remonetized, and this is showing up in improved capital account figures. There has been a significant increase in gross foreign exchange reserves. As of end 2000, these stood at $3.5 billion, or equivalent to about six months of import cover. By contrast, gross foreign exchange reserves were only $0.8 billion-equivalent at end 1996, roughly one month of import cover. This is all the more impressive as imports have grown steadily in recent years.

One of the major reasons for Bulgaria's stronger balance of payments position is the increase in foreign direct investment, even though portfolio outflows have been negative since 1998. In 2000, this amounted to $1 billion, or 8 percent of GDP, as compared with a mere $138 million in 1996, or 1.4 percent of GDP. While much of the FDI was previously put into the manufacturing sector, most of it related to the two major bank privatizations (UBB and Bulbank) in 2000. This will serve as a stimulus for domestic spending on MIS/IT and personnel, and have the larger effect of intensifying competition in the banking sector. Meanwhile, **the debt profile continues to improve**, with external debt declining from nearly 97 percent of GDP in 1996 to 86 percent at end 2000.

Overall, Bulgaria's balance of payments are showing improvement. The results achieved in the last few years stand in stark contrast to the balance of payments crisis through the current account in 1993, and finally the capital account via declines in reserves in 1996. However, as before, **Bulgaria runs the risk of slowing progress due to incomplete reforms at the structural level**. While the previous government was effective at curtailing financing of inefficient state enterprises, the new government will need to complete the reform effort in the enterprise sector (accompanied by major judicial reform for better private sector incentives) to sustain progress towards competitiveness. Short of that, **Bulgaria will be vulnerable to a slowdown in the Euro-zone economies**, particularly as its own domestic economy with 8.2 million people is still relatively small and limited in terms of aggregate long-term purchasing power. **Meanwhile, any export slowdown with its EU trading partners cannot be easily offset through trade, as nearly 25 percent of imports are energy products from Russia**.

Section 3: Assessment of Banking Structure and System Profile

III. Banking Structure and System Profile: Score: 3-/3 *(vs. 2+ in 1998)*

Bulgaria was at the beginning of the adjustment process in the banking sector in 1997. Major legal and regulatory reforms were introduced in 1997-98. Technical assistance was on the ground to shore up institutional capacity in banking supervision, and to help establish a plan and implement bank privatization. At the time, it was hard to even get a sense of basic asset values, given hyperinflation, the lack of active and transparent markets for fixed assets, and the deep problems of the loan portfolio. There was virtually no concept of risk management in place (apart from a few of the major foreign banks that had established small banks or branches), and the incentive structure was geared to political patronage and forbearance rather than commercial viability and cash flow.

Since then, conditions have vastly improved. Five of the six major banks slated for privatization have been privatized, and the last remaining bank is not a major bank. **While four other banks remain state-owned and should be privatized, 80 percent of the banking system is now privatized and largely foreign-owned. Banks have high capital adequacy ratios, and asset quality is better than a few years ago.**

Recent foreign investment is serving as a catalyst for increasing competition in the small corporate market, and for new investment in retail expansion that is expected to significantly increase the penetration rate of banks in the enterprise and household sectors. New systems are being put in place to manage associated risks. These investments and systems are expected to add to product offerings, with the anticipated effect of growing bank balance sheets and increasing intermediation levels. All of this should spur on continued economic growth.

While growth and intensified competitiveness are projected, consolidation is also projected. With 35 banks, Bulgaria is likely to see this number decline in the coming years. There is nothing wrong with this development. In fact, this should help, as many of the banks have low levels of aggregate capital, and little to offer the marketplace in terms of loan size or non-credit services apart from rudimentary safekeeping.

In anticipation of these developments, **one of Bulgaria's most critical needs is to devise a strategy for bank resolution**. This can be done in a number of ways. One approach is to create incentives to consolidation prior to the risk of deteriorating bank-specific financial conditions. Raising levels of minimum capital is one technique. Regulatory inducements are another. Short of that, BNB and the government will need to think through the potential economic cost of having a large number of small banks that could potentially engage in practices that could harm system stability overall. Nonetheless, for the time being, this does not appear to be a major risk. Overall, the banking sector is now financially stable and poised for growth.

By contrast, in the non-bank sector, little has occurred. The securities markets are weak and characterized by low turnover and market capitalization. The insurance sector is underdeveloped and in need of a strategic framework to ensure that companies are financially sound, committed to observing standards of consumer protection, and able to properly monitor the risks associated with their underwriting practices. **Recent pension reform bodes**

well for private savings, although there are doubts about the size of voluntary contributions to be made in the coming years as long as purchasing power remains relatively low. Meanwhile, mandatory contributions will also be sub-optimal until tax avoidance/evasion declines to more modest levels. If contributions do not reach targeted levels, **the authorities will need to also have a contingency plan in place in the event that one or more private pension funds come under financial stress. This is also the case in the insurance sector** if a firm is financially troubled and unable to honor claims. Beyond that, there are opportunities to develop leasing, factoring, commercial finance, mortgage lending and other financial services. However, these markets remain largely underdeveloped.

The quality of management and governance varies, although standards are largely improving with modernization and competition. While the foreign-owned banks and many of the more competitive domestic banks are considered sound in terms of board composition, management capacity, internal controls, and systems, there are other banks that are not considered as strong. Without regulatory controls, some of these banks would otherwise pose a potential threat to systemic stability. In the meantime, many of the older banks that have not attracted new capital and shareholders are reported to require improvements in board composition, management capacity, organizational structure, and quality of information. Some of these problems can be remedied by introducing independent and outside board members (particularly for Audit Committee participation), increasing checks and balances in management roles and responsibilities, reconfiguring existing top-down structures to be more horizontal in their functions, establishing better channels of internal communication, and maintaining closer and more regular links with external auditors.

The new government will need to address the "strategic framework" issues in a more organized fashion now that they have embarked on accession negotiations with the European Union. Several market players and others have commented that legal and regulatory changes are haphazard and frequent, and that this undermines confidence and planning for the future. Specific examples of policies that work at cross-purposes, or problems associated with the need for better harmonization across financial products and services are commonly noted. Now that the system has stabilized and the financial sector is poised for growth, it may be in the interest of government policy makers, various financial regulators, and market players across the financial services industry to participate in a comprehensive strategic framework exercise to smooth out these inconsistencies. While broad in scope, this would likely provide the needed clarity of freedom and maneuverability for financial institutions at a time when they are planning for growth and expansion.

3.1. Overview: Score: 3- *(vs. 2 in 1998)*

Bulgaria has made impressive progress since 1997 in stabilizing the banking system, and putting it in a position for growth and diversification. The system is now dominated by strong regional banks (from Italy, Greece and Austria), supplemented by prime-rated global banks (from the Netherlands, France, Germany and the U.S.). While the system is still small, at less than $5 billion in total assets, it is poised for growth due to high capital and liquidity ratios, and relatively clean loan portfolios.

There are clear indications that bankers have confidence in Bulgaria's future prospects. As an example, many of the global players are currently investing in retail networks, rather than keeping their operations focused on low levels of risk and off-balance sheet activities. While banks have been criticized in recent years for not lending, they are now tooling up to do more than lend. Their current agenda is to provide a wide variety of products and services to enterprises and households, with the intention of diversifying their earnings stream and moving away from passive, low-return investments in low-risk securities and paper (mainly abroad).

Increasing competitiveness is likely to improve overall offerings and service levels. Nonetheless, it will also put pressure on the weaker banks. **With 35 banks in Bulgaria, about half of which are either small and/or weak, it is expected that many of these will disappear in the coming years**. There is a risk that such pressure could lead to political patronage, selective forbearance, and other practices inconsistent with market-based rules of engagement. There are several other risks that could materialize as a result of such pressure, including losses resulting from adverse selection, aggressive pricing on deposits to increase funding unavailable in the inter-bank market, and imprudent use of lender of last resort provisions. **A clear, consistent and sound framework for bank consolidation and resolution needs to be developed in anticipation of such possible developments**.

Donors also present a risk, as subsidized loans can lead to market distortions and support for institutions that otherwise would not survive. Extraneous investments for portfolio purposes can also encroach on market development. Thus, **given that the market is now poised for real growth, donors' involvement should be less on direct financing of projects through institutions (or on equity investments in the already over-capitalized banking sector), and more on building the needed infrastructure (e.g., laws, regulations, institutional capacity) for market development to proceed under stable conditions**.

3.2. Ownership: Score: 3+ *(vs. 2 in 1998)*

The banking system has gone through a major reconfiguration of ownership since 1997. As of end 1997/early 1998, the banking system was heavily weighted towards state banks. Since then, most of the major banks have been privatized, primarily by attracting strategic investment from abroad. This transformation includes the sale of nearly 100 percent stakes in Bulgaria's two largest commercial banks in 2000 to Italian and Greek banks. At least another 20 banks are at least partly foreign-owned, accounting for a total of about 70-75 percent of banking system assets.

At the end of 2000, only about 20 percent of assets remained in state-owned banks. This is in stark contrast to the 82 percent share at end 1996 and 66 percent share at end 1997 (due to the closure of smaller insolvent banks). Of the remaining state-owned banks, two (Biochim and Central Cooperative) have already begun initial privatization discussions. A third, DSK, is the former state savings bank that operates under a fairly narrow set of restrictions with regard to lending. A fourth, Promotional Bank, was established to encourage lending to SMEs. **It**

would behoove the new government to move forward as rapidly as possible with privatization of these state banks to avoid the risk that they could be used in the future to revive earlier practices of connected lending.

3.3. Governance and Management: Score: 3- *(vs. 2+ in 1998)*

Governance and management have improved in most banks since 1997, although there are still reported to be many weaknesses at the smaller banks. Positive developments include the risk management expertise that has been a part of foreign bank privatization, improved MIS, investment in IT, development of the internal audit function, increasing use of international standards of accounting and audit, and stricter qualifications required of board members. Much of this derives from improvements and changes that were introduced through laws and regulations adopted in 1997-98.

In terms of governance, there is a commitment to holding boards responsible for the business plans of their banks, satisfactory internal controls and reporting, and compliance with laws and regulations. Management is expected to implement these plans accordingly. **The larger task now is how banks will manage risks as conditions become more competitive**. This transcends fundamental credit risk, and is likely to take on a more consolidated profile over time as banks eventually enter insurance markets, increase their roles as investment intermediaries for private pension funds, and expand their activities in the capital markets (via brokerages as well as potentially as institutional investors). For smaller banks where management capacity may not be as deep, this challenge is likely to create additional operational and informational problems that will need to be tackled to ensure risks are under control.

These will also be critical challenges to BSD at BNB, both for off-site surveillance and the workings of the early warning system, and the on-site department to follow up on a timely basis with targeted examinations. As banks diversify, this will also require sound and timely coordination among the various financial services regulators. The hiring of BNB personnel by some banks may help with regulatory and systems compliance, and the internal audit function. If so, this represents a contribution to corporate governance and management capacity in the banking sector. This will likely be tested in the coming years.

3.4. Non-Bank Competition: Score: 2 *(same as in 1998)*

There is still limited competition for and complementarity to banks in the marketplace, which has also perpetuated the notion that banks should provide the vast majority of funding for enterprises. It is not uncommon to look to banks to play this role, particularly as traditional universal banks in continental Europe tend to play a more concentrated role in the financing of enterprises than in other markets. Nonetheless, with the introduction of modern prudential norms, banks are simply unable to provide the amounts of financing demanded, even if the banks would like to. This is due to basic restrictions on large loans, concentrations of exposure, etc.

Among other financial services, **the capital markets are weak in Bulgaria**. They are characterized by low turnover, which is all the weaker on average due to the disproportionate role of block trades on an otherwise illiquid market. Market capitalization for the entire Bulgarian Stock Exchange was less than $500 million at end 2000. Future moves to increase regional links, enhance OTC opportunities, and make trading more transparent would all help with securities market development.

Contractual savings instruments are beginning to appear, particularly with recent pension reform. Bulgaria introduced reforms in 2000 to move to a sustainable three-pillar scheme. Since then, nine active pension funds have attracted more than 400,000 insured and $35-$50 million to their voluntary funds in the first year or so of operation. While this signifies progress, it is unclear the degree to which people born after 1959 will continue to make contributions for future retirement benefits should their purchasing power remain relatively low. Meanwhile, insurance activity is beginning to increase, including in the life insurance sector. Life insurance was about one third of total premium revenues in 1999, or about $100 million-equivalent. It will take time for contractual savings instruments to capture sizable market share, and for these funds and companies to be in a position to play a major role as institutional investors.

There is limited development of factoring, commercial finance, leasing or other types of financing that could serve as either competitors to or partners of banks. Some bank financing of leasing activities occurs, and some of the banks' lending to companies is comparable to commercial finance in more developed markets. There has been some initial mortgage lending, although this has not become a major activity yet for banks or non-banks.

Section 4: Assessment of Banking Sector Development Based on Prudential Norms

IV. Banking Sector Development Based on Prudential Norms: Score: 3 *(vs. 2+ in 1998)*	**Bulgaria has accomplished a great deal since 1997, not the least of which is stabilization of the banking sector, implementation of an improved prudential regulatory framework with which the banks are able to comply, and a general framework for sustainable growth and development of intermediation capacity that is prudently managed relative to risk assumed**. Capital adequacy is high, which reflects substantial extra capacity. Asset quality has improved significantly, with standard loans now 92 percent and loss loans less than 4 percent. Liquidity ratios are high, partly a reflection of banks' limited alternative investment opportunities. Thus, CAL measures are generally strong, notwithstanding adjustments that may occur between preliminary figures issued by BNB and externally audited statements. **However, banks' earnings are not particularly strong, partly because their approaches have been conservative**. Even when companies are known to be credit worthy, their inability or unwillingness to comply with underwriting standards has translated into investments in low-return paper and securities, usually in offshore banks, rather than lending to Bulgarian enterprises. This is beginning to change now that competition is heating up. Moreover, banks' 20 percent return on average capital and 3 percent returns on average assets are not bad for a low risk environment. However, given the small base of activity, overall earnings are limited, particularly for many of the smaller banks. Thus, moving forward, banks can be expected to take on more risk in pursuit of higher earnings. **The trend towards greater risk assumption will require adequate risk management systems to be in place**. The investment-grade international and regional banks have this capacity. It remains to be seen how much risk other banks will take in the Bulgarian marketplace, and how well they will manage these risks. This will need to be monitored carefully by BSD, as well as by the banks in assessing their exposure to the inter-bank market. This will primarily focus on fundamental credit risks, but also on underlying mismatches or gaps regarding interest rate features, exchange rates, and maturities. This will call into question not only the management capacity of individual banks, but also the efficiency and timeliness of MIS and the ability of individual banks to identify and contain risks early on to prevent adverse effects on portfolio quality and earnings.

4.1. Capital Adequacy: Score: 3 *(same as in 1998, although this is now viewed as high in retrospect)*

Bulgaria's banks are currently "overcapitalized" in terms of CARs, while being relatively small on average in terms of actual capital. CARs at end 2000 were about 36 percent. Even with some adjustments after audited statements, this suggests that banks have excess capital relative to risk-weighted assets. **Now that banks are poised for growth and seeking higher earnings, it is assumed that they will more actively deploy their capital**.
In terms of aggregate capital, **the Bulgarian banking system had about 1.4 billion leva at end 2000, or about $656 million. This averages about $24 million per bank net of foreign bank**

branches. Thus, the average bank cannot generally make loans in excess of $2.4 million, which is very small by international standards.

4.2. Asset Quality: Score: 3 (same as in 1998, although this is now viewed as high in retrospect)

Based on preliminary year end BNB figures, **the banks' loan portfolios remain satisfactorily provisioned, with most loans standard (92 percent) and loss loans under control (3.4 percent). This represents a major improvement from only 79 percent standard loans at end 1997, of which a substantial portion of the balance were loss loans**. Since then, banks have been very conservative in terms of their lending policies. Loans have been more than fully secured (at least in terms of paper value), and a majority of earning assets have been placed in primarily investment-grade paper in offshore banks. The positive side of this approach has been risk containment. The negative side has been relatively unimpressive earnings, passive approaches to asset management, and foregone opportunities for economic development.

4.3. Management: Score: 3 (vs. 2+ in 1998)

There have been improvements in management due to the strengthened incentive structure introduced into the banking system in 1997-98. However, because banks have still not moved forward aggressively in assuming more risk, **it is too early to evaluate how adequate systems are, and how much better prepared management teams are to identify and contain problems when they emerge**. It is expected that the major foreign banks will be able to handle these problems based on their experience from abroad. However, there are questions about the ability of Group IV banks in particular to manage these risks.

Beyond that, there are also fundamental organizational issues related to efficiency and the management of cost structures. In general, banks have high costs, and their net earnings are largely based on low rates of interest paid on deposits. Market competition will test these banks' capacity to adapt to more active management of risks and costs.

4.4. Earnings: Score: 3- (vs. 2 in 1998)

Banks have shown positive earnings since 1997, although in 1997, this was due to translation adjustments. **Since 1998, earnings have been relatively meager due to low levels of risk assumption on the asset side. Margins have been made less on cost effectiveness or new efficiencies, and more on the basis of negative real rates paid on deposits**. Banks have generally not yet built up a diversified stream of non-interest earnings, although Bulbank appears to still generate reasonable returns on trade-related services. Apart from this, the earnings stream has been adequate—ROE and ROA were 20 percent and 3 percent, respectively, in 2000—but the mass of earning assets is not yet large enough for total income to be of any particular significance. **For 2000, average net earnings per bank were less than $4 million. Even if fully retained, this is not enough for the kinds of investments and systems needed for modern banking**.

4.5. Liquidity: Score: 3 (same as in 1998)

Bank liquidity ratios are high, partly reflecting regulatory requirements and partly reflecting risk aversion on the part of the banks. This is apparent in the pattern of asset management since reserve requirements were reduced from 11 percent to 8 percent. In most markets where intermediation rates are low, banks would have used the differential for lending to generate higher earnings. However, banks generally placed most of these funds in the same low-risk offshore bank paper that had been the destination of most of its other earning assets. Banks have followed this approach for several reasons, all of which are prudent. First, loans need to be more than fully collateralized, otherwise banks need to provision against the unsecured portion or the loan as a whole. Second, there is clear risk associated with lending in Bulgaria. Third, it is administratively cheaper for banks to simply place funds in offshore bank paper, rather than undertaking the hard work involved in underwriting credit risk. Fourth, offshore bank paper is readily marketable. Finally, it is easier for banks to comply with regulatory requirements. Thus, banks have been prudent to maintain high liquidity ratios.

The downside to all of this has been the relatively low returns banks have earned as a result of these approaches. Now that margins have begun to shrink in the corporate lending market, and because there is little government securities market from which to generate safe returns, many banks are now looking to take on more risk. This should bring liquidity ratios down, yet lead to higher earnings. Given the low aggregate earnings of the system in 2000, these kinds of developments are inevitable in developing a modern banking system. However, **banks and regulators will need to continue to monitor fundamental interest rate, exchange rate, pricing and maturity gaps to ensure that individual banks do not push the limits and endanger their ability to honor deposit withdrawals, guarantees, and other transaction requirements**. For the foreseeable future, this is not expected to be a problem. It is also expected that movement to RTGS will help banks with their liquidity management practices.

4.6. Operating Environment: Score: 3 (vs. 3- in 1998)

The operating and regulatory environment has improved in Bulgaria since 1997. **Laws and regulations largely conform to Basle and EU standards, and banking supervision has asserted itself with general enforcement of its mandate**.

Accounting standards are evolving increasingly towards IAS. External auditors have been used not only for annual audits, but also to point out improvements needed at banks with regard to MIS, IT, internal audit, and other building blocks of a modern banking system.

Deposit insurance is now in place, and an active fund supported by mandatory bank contributions has been established with borrowing authority to provide reasonable coverage. While insufficiently capitalized to date, this has to do with the relatively recent introduction of the deposit insurance fund. Two banks have been closed and deposit payouts orchestrated within 45 days. There was no public panic, suggesting that households and enterprises with deposits feel relatively confident their deposits are safe.

The government curtailed bank refinancing with the CBA, and **the lender of last resort function is limited to secured lines for liquidity support to viable banks that have run into short-term liquidity problems**. There has been no reported use of this function since the CBA was introduced in mid-1997.

Concentration has diminished as the market has opened up to competition. Bulbank and DSK retain strong positions in traditional activities. However, balance sheet indicators show a reduced level of concentration. Meanwhile, Bulbank has been privatized, and DSK has been required to operate under restricted lending conditions. Meanwhile, DSK also had its state guarantee on deposits removed as a condition of its ongoing right to operate.

4.7. Transparency and Disclosure: Score: 3 *(vs. 3- in 1998)*

The banking laws introduced in 1997 reflected a commitment to greater transparency and disclosure in the marketplace. Nonetheless, practices had not yet been reformed. By contrast, **there is a great deal more transparency and disclosure as of early 2001**. BNB and most banks have active web sites. New accounting standards, more open financial media, and a general opening of the market have helped to increase information flows.

Notwithstanding progress, pockets of weakness continue to exist. The BNB credit registry does not provide public information on borrowers, nor are there publicly disclosed ratings of banks apart from the rare ratings established by international rating agencies. The sluggish development of the capital markets has also undermined the push for greater transparency and market activity.

4.8. Sensitivity to Market Risks: Score: 3 *(vs. 2+/3- in 1998)*

Conditions have stabilized in Bulgaria since 1997, as demonstrated by improved portfolio quality, system earnings, nearly complete bank privatization, improved standards of governance and management, better control over mismatches, and Bulgaria's resilience in the face of economic, financial and political crises that have impacted various regional and neighboring markets. **This is a major accomplishment, considering that the country's economy was in a state of collapse at the end of 1996-early 1997**.

Moving forward, it can be expected that **the Bulgarian banking market will encounter greater volatility as a result of increased competition**. This will result in increased earnings and lending, diversification of products and services, introduction of more complex services that generate fees and commissions, and consolidation from 35 banks to a smaller number. Along the way, there are likely to be periodic losses or portfolio erosion that can spread to other banks and the system at large. This may be through the inter-bank market, as a result of certain alliances across financial services, or simply due to reputation and the concern the public may have on fundamentals such as deposit safety.

Most of the risks banks face in the next few years will be basic to banking—credit, interest rate, exchange rate, pricing, maturity. Banks will need to ensure they have adequate systems for credit risk evaluation and continuous loan monitoring. Being aware of who has controlling interests in borrowing companies will be essential in preventing serious losses from occurring. Strengthening the enforcement of creditors' rights through the court system will be needed. Likewise, when a bank fails, a more developed resolution framework will need to be in place for orderly liquidation. However, Bulgaria is not currently burdened with high levels of risky derivatives trading, excess guarantees, or over-exposed trade financing arrangements. Likewise, while banks are beginning to move into non-bank activities like insurance and private pension funds, these are generally being pursued as enhancements to their operations without putting fundamental balance sheet items at risk.